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August 26, 1993

BY MESSENGER

Mr. William Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Room 222
Washington, D.C. 20554

Re: MM Docket No. 93-215

Dear Mr. Caton:

Enclosed are an original and nine copies of the Affidavit of Richard D. Emmerson, to accompany the Joint Comments of Bell Atlantic, the Nynex Telephone Companies, and the Pacific Companies in Response to Notice of Proposed Rulemaking. The Joint Comments, which were filed yesterday, included a telecopied facsimile of Mr. Emmerson's affidavit. The enclosed version is identical to the facsimile. Please substitute it for the copies filed yesterday.

Thank you for your cooperation.

Sincerely,

Mark L. Evans
Attorney for the Joint Commentors

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FEDERAL COMMUNICATIONS COMMISSION
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Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	))))))	MM Docket No. 93-215

AFFIDAVIT OF RICHARD D. EMMERSON

Introduction

My name is Richard D. Emmerson. I am President of INDETEC Corporation. My business address is 341 La Amatista, Del Mar, CA. 92014. My academic qualifications include a Ph.D. in economics and I was a full time member of the Economics Department at the University of California, San Diego (UCSD) from 1971 through 1979. I continue to teach occasional courses at UCSD and, until the end of 1991, I was the Director of the Executive Program for Scientists and Engineers at UCSD. I have served as an expert witness in antitrust, business, and other litigation involving economic issues. I have testified before many Public Service Commissions on the subjects of access charges, bypass, rate structure, competition, pricing, costing methodologies, and market structure. I have worked in a similar capacity in several foreign countries as well.

I have been asked by the NYNEX Telephone Companies and the Pacific Companies to address specific economic issues raised in the Federal Communication Commission's Notice of Proposed Rulemaking in MM Docket No. 93-215 dated July 16, 1993. Specifically, I will discuss the application of regulatory and reporting rules for cable TV companies as they pertain to promoting economic efficiency.

Introduction and Summary

In regulating cable TV companies, it is important for the Commission to promote the economic efficiency associated with competition. Additionally, it is important for the Commission to encourage an optimal rate of development of new products and services and the optimal rate of adoption of new technologies. Symmetrical regulation of cable TV companies and local exchange carriers is necessary to promote competition, economic efficiency, and the optimal rate of technology deployment and the development of new products and services. By "symmetrical regulation," I mean that cable's provision of cable entertainment services should be regulated in the same manner as local exchange carriers' provision of telephone services. In particular, while I do not necessarily believe that all the various accounting, cost allocation, and affiliate transaction rules that apply to local telephone companies are necessary, as long as the Commission continues to apply these rules, they should apply equally to cable as well.[1] The following guidelines would promote these outcomes.

[1] These rules become unnecessary under a pure price-cap regime.

- Cost reporting and price and revenue restrictions should apply equally and symmetrically to competing companies.
- Accounting practices such as the reporting of annual expenses, the rate base, and return on assets should be performed in symmetrical and comparable terms using comparable (if not identical) charts of accounts.
- Distortions which can be created through affiliate transactions and transfer pricing should be prevented.
- Care should be taken to avoid "market" prices which are reflective of monopoly profits in the valuation of assets and the associated reporting of expenses.
- Cost allocation rules should be applied symmetrically and identically to competing firms in a manner that does not distort the relative efficiencies of the competing firms.
- Rules should avoid encouraging the creation of unnecessary and wasteful sunk costs. Proper measurements of costs based on the respective competitors' actual resource utilization is required to eliminate incentives for inefficient expansion utilizing monopoly profits.
- Proper safeguards against cross-subsidization, anticompetitive behavior, and discriminatory behavior should be applied equitably and uniformly to all competing providers of service.

Importance of Economic Efficiency

An important goal of the FCC is to promote a combination of regulation and competition which leads to rates resembling those of a *competitive system*. It is widely recognized that effective competition promotes the public interest. Thus, both competitive behavior and its resultant, economic efficiency, are critical to the regulatory treatment of cable TV companies wishing to compete within the telecommunications market.

Occasionally, public policy objectives and the goal of economic efficiency conflict. Indeed, balancing the various interests when such conflicts arise has been one of the most difficult tasks of regulation in our economy. Nevertheless, certain minimum criteria regarding economic efficiency have provided constraints within which public policy objectives are met. Among these criteria are preventing cross-subsidization, preventing anti-competitive behavior such as predatory pricing, avoiding forms of discrimination which are inconsistent with competitive systems, and encouraging the development and implementation of optimal technological changes and diverse new services.

One of the most important outcomes of good regulation and competitive markets is productive efficiency. Productive efficiency means that the products and services produced in our economy are produced with the least-cost combination of resources. This is the primary use of cost in establishing price floors; the firm with the lowest cost of producing a service will survive in the marketplace because it can price at a level which precludes inefficient producers from the market while sustaining a profit (or positive contribution). Thus, a necessary condition for economic efficiency is that a firm avoid cross-subsidizing a competitive service with services for which it has some monopoly power. If a firm were allowed to price a competitive service below cost, more efficient producers may be precluded from producing the service. Thus, a minimum requirement of a regulatory regime is to prevent firms from exercising potential monopoly power to cross-subsidize competitive services.

The Optimal Rate of Development and Diversity of New Products

Asymmetrical regulatory rules applied to cable TV companies and local exchange companies may hinder the optimal rate of technological progress and the optimal diversity of services offered. Competitive firms seek to increase profits in economically efficient ways. For example, increased profits can be obtained by reducing costs; competitive firms operating under a profit motive will therefore strive to achieve productive efficiency. Competitive firms also seek to increase profits by finding opportunities to acquire resources at market prices and convert those resources into more valuable forms as reflected by consumer prices in excess of the cost of the resources consumed. That is, the competitive process transforms raw resources into more valuable finished assets wherever such opportunities can be found. This incentive leads to a persistent search for new ways to fulfill customers' needs and satisfy their desires. Technological advancement and product diversity is thus the result of constantly seeking lower costs and more efficient ways to do business, and constantly seeking new products and services of social value.

Regulatory rules which distort either the price obtainable for new services in the marketplace or the cost of providing the new services will result in suboptimal technological change and product diversity. To the extent that restrictive regulatory rules are desirable (perhaps for social policy reasons) and resulting distortions are unavoidable, it is important that the rules are applied consistently and symmetrically to all competing parties in order to leave their *relative* costs and profit opportunities undisturbed.

Unnecessary Investment and Sunk Cost

A particular risk in applying asymmetrical regulatory rules to cable TV companies is the creation of unnecessary and wasteful sunk costs. For example, symmetrical cost allocation rules can ensure that captive cable ratepayers do not finance cable construction of excess capacity for the provision of telephone service.

Cost Allocation Rules

The reported costs of competing services provided by both local exchange companies and cable TV companies must be based on the actual resources consumed and the actual technologies used by the respective competitors. Economic efficiency is defined and measured with respect to the value of resources consumed; this fact should be reflected in the reporting of costs.

The Commission should employ economically sound costing principles which are consistent with competition and economic efficiency in regulating both telephone companies and cable TV companies. I have long advocated the principles of cost causation and the resulting incremental cost information as superior to accounting cost allocations for this purpose. In balancing public policy objectives against economic efficiency, the FCC has seen fit to allow certain cost accounting practices to evolve into forms which accommodate the evolution of competition itself. As this practice proceeds, it is critical that symmetric and equal rules be applied and *concurrently* adjusted for both telephone companies and cable companies so that the most efficient communications markets develop.

To the extent that costs other than those associated with incremental resources consumed are employed in regulatory safeguards to prevent cross-subsidization, the allocation rules pertaining to these costs must not disturb the measure of the *relative* efficiencies of the competing firms. For example, if one firm can provide a telecommunications service by consuming a lower value of resources than a second firm can, the cost allocation rules must not force the more efficient firm to charge the higher price. This outcome can only be accomplished by applying carefully constructed cost allocation rules in an identical manner to both firms. This requirement is not only necessary for economic efficiency and the optimal development of both cable TV and telephone markets, but is also necessary for fair and nondiscriminatory treatment of the competing parties.

Accounting Practices

To avoid distorting the development of competition between cable TV and telephone companies, symmetric accounting rules must apply. The monitoring of cable TV companies with respect to cost allocation, accounting, and affiliate transaction practices requires, at a minimum, a chart of accounts which is of the same form and content as that applying to telephone companies.

Accounting practices can distort the reported costs of competing firms in a manner which is incompatible with competitive prices and economic efficiency. For example, if competing firms employ similar facilities to provide similar services but report depreciation according to different depreciation lives or rules, equally efficient firms will not be reporting equal costs. It is important, therefore, that like facilities which provide competing services in a similar manner be subject to the same accounting practices.

Distortions can also result from accounting practices in the recording of transfer prices. A well known problem in transfer pricing, for example, is the avoidance of taxes by transferring products and services from low tax jurisdictions to high tax jurisdictions at inflated prices (prices in excess of market prices). This increases the deductible expenses in high tax jurisdictions and correspondingly increases the profits shown in low tax jurisdictions. Similar accounting practices can be used by a competitive firm in order to understate its cost of competitive services while overstating the cost of monopoly services. Symmetric and equitable rules of accounting should pertain to any transfer pricing which is undertaken by cable TV companies and local exchange companies in their competing markets.

A third potential area in which accounting practices can work contrary to competitive prices and economic efficiency is in the valuation of company assets. If a company has market power in any of its various markets or submarkets, the monopoly profits are often included in the calculation of an acquisition price (possibly recorded as a *market value*). If a company or its assets are purchased at a price which recognizes such monopoly rents, its overall level of accounting profits and its reported contributions from individual products and services may appear to be normal when, in fact, they are excessive. A common solution to this problem in the regulatory environment is to require the reporting of assets at original cost. In any case, the competing entities should be required to engage in consistent and non-distortive accounting practices.

Affiliate Transaction Rules

Prices associated with transactions between affiliates can result in the same potential distortions as those due to using transfer prices which are not reflective of market prices or the cost of actual resources transferred. In particular, affiliate transactions sometimes involve the transfer of products and services which are not traded in competitive markets and, therefore, have ambiguous market values. In instances where there is no competitive market price to provide a point of reference, the Commission has rules in place for the telephone companies to establish a transfer price, and these rules should be consistently and symmetrically applied to competing firms. If affiliate transaction rules are not symmetrically applied, the more efficient firm may be put at a competitive disadvantage.

For example, if a cable TV firm were to buy programs from an affiliated company at an artificially inflated price, and were the "cost" of the cable TV company to be reported based on the affiliate transaction, the excess profits obtained from the exercise of monopoly power in the cable TV market would be masked. The cable TV company, under these circumstances, could report seemingly "normal" profits but use those profits to price its competitive telephone services at a level below cost. This may allow the cable TV company to underprice the local exchange company (which may be the more efficient provider of the telephone service). This form of cross-subsidization is contrary to both traditional regulation and economic efficiency, absent some form of overriding public policy considerations such as universal service.

Discriminatory and Anticompetitive Behavior

Anticompetitive and discriminatory practices are generally inconsistent with competitive prices and profits. Laws pertaining to both anticompetitive and discriminatory behavior of firms do currently exist. It is important, therefore, that the Commission not provide incentives contrary to these laws. The application of asymmetrical regulatory rules to cable TV companies vis-à-vis their competitors would provide asymmetrical incentives for the competing firms to behave in the marketplace. This provides "room" (excess profits) for discriminatory and anticompetitive behavior by removing the disciplinary function of competition. The Commission should generally not interfere with voluntary selection of technologies and means of production, the voluntary selection of prices in the marketplace, and the useful incentives contained in the profit motive. The one exception to this rule is the application of regulatory restrictions where there is a clear potential for one or another firm to exercise monopoly power. The exercise of monopoly power should be controlled and contained by the application of antitrust laws and regulatory oversight.

Conclusion

The Commission should encourage economic efficiency, the optimal development of new services, and deployment of new technologies. To promote these goals, it is critical that cable TV companies be regulated consistently and symmetrically with their local telephone company competitors. As a result, to the extent the Commission continues to apply accounting, cost allocation, and affiliate transaction rules to telephone companies, it should apply symmetrical rules to both industries.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on August 24, 1993

Richard D. Emmerson